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Treatment of Islamic financial instruments under the United Nations Model Double Taxation Convention between Developed and Developing Countries*

Summary

The present paper provides a brief presentation of the main Islamic financial instruments and examines the tax treatment that would, in principle, apply to these instruments under the United Nations Model Double Taxation Convention between Developed and Developing Countries.

Income from most of these instruments should, in principle, be regarded either as business income, dividends or income from immovable property depending on the type of contract and the underlying asset.

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I. Introduction

1. Islamic finance has witnessed remarkable development during the past few decades. Total worldwide assets are estimated at between $200 billion and $300 billion, with an average 15 per cent increase per annum. Islamic finance refers generally to financial services and activities that are compliant with sharia (Islamic law) requirements, the latter being based on the holy Quran and the Sunnah (tradition) of the Prophet Muhammad.

2. There are three major distinctive elements that characterize Islamic finance, namely, the prohibition of *riba* (interest), the prohibition of *gharar* (uncertainty or risk) and the prohibition of *maysir* (gambling). The term *riba* means excess or increase. Legally it extends beyond the concept of interest, but in simple terms we may say that *riba* covers any return of money on money. It covers, therefore, all types of interest (regardless of the rate), whether fixed or floating, simple or compounded. *Gharar* means, in simple terms, any element of uncertainty in any business or contract about the subject or the price of the same. It means also mere speculative risk. *Gharar* is prohibited on the grounds that, inter alia, it leads to undue loss to a party and unjustified enrichment of other. *Maysir* can be defined as including all types of hazard and gambling games.

3. In summary, Islamic finance prohibits all forms of interest, uncertainty and gambling, and focuses on profit-sharing and linking finance to productivity. The present paper is an attempt to present the main contracts, transactions and instruments available under Islamic finance (section 2) and to identify the provisions of the United Nations Model Double Taxation Convention between Developed and Developing Countries under which they would fall (section 3).

II. Presentation of main contracts

4. Islamic financial instruments may be classified in the following categories: (a) equity (or profit and loss sharing) instruments; (b) debt instruments; and (c) quasi-debt instruments. We will also examine *sukuk* as a way of securitization of the aforementioned types of instruments.

A. Equity instruments

5. Equity instruments include *musharaka* and *mudaraba* contracts. They are presented as the purest or the ideal forms of permissible contracts in Islamic finance because they spread the risk inherent to a project between all involved parties. In practice, however, they do not represent a significant share in the activities of Islamic banks.

Musharaka

6. Literally, *musharaka* means partnership. It is an equity participation contract whereby the partners or shareholders (usually the bank(s) and the client(s)) contribute jointly to finance a project. Profits and losses are split according to a pre-agreed formula. The *musharaka* may be compared to partnerships, limited partnerships or joint ventures.

Mudaraba

7. The *mudaraba* is an investment partnership whereby an investor (called also *rabbul mal*, or owner of money) agrees to provide money to another party (called also *mudarib* or entrepreneur) in order to invest the same or undertake a business activity. Profits are distributed on the basis of a pre-agreed formula, while losses are borne exclusively by the investor. The entrepreneur will not receive any income in case of loss.

8. As described above, the *mudaraba* contract may be compared to a contract with an investment fund.

B. Debt instruments

***Murabaha* (cost-plus financing)**

9. Literally *murabaha* means a sale on mutually agreed profit. Technically, it means a contract whereby the capital provider (bank), instead of lending out money, purchases a commodity, on the request of the capital user (client), from a third party and resells it at a predetermined higher price to the capital user. The latter will pay the price in instalments, obtaining thereby a credit without paying interest. The *murabaha* contract is comparable to the sale and repurchase (repo) agreement used under the conventional banking system.

Bai salam

10. *Bai salam* refers to a sale transaction whereby the seller undertakes to provide a specific commodity to the buyer at a future date against an advanced price (which is usually less than the market price of the commodity). The seller obtains, therefore, immediate cash, and will have to supply the commodity at a deferred date. This technique has been usually used by farmers.

Istisna'a

11. Under this type of contract, the Islamic bank finances the costs of supplies and labour of a project and sells the project to the client. The latter will pay the advanced amounts (with a profit margin) to the bank from the revenues derived from the project. The *istisna'a* contract can be used for financing such projects as the construction of plants, manufacturing projects, bridges, roads and highways, etc. Usually, Islamic banks enter into a "parallel" *istisna'a* contract with a contractor who will effectively build the project.

***Qard Al-Hasan* (benevolent loan)**

12. This is an interest-free loan granted by Islamic banks. Usually, banks levy a service charge to cover their expenses. This charge may not exceed a limit set by the authorities. A variety of this type of loan is the no-cost loan granted by Islamic banks to needy persons such as small farmers, small producers, needy consumers, etc. The bank, which is expected to set aside part of its funds to finance these loans, will not derive any income or charge any expense on the loan.

Quasi-debt instruments: *ijara* contract

13. The *ijara* contract is a leasing contract whereby the Islamic bank, instead of lending money, owns the asset and leases it to the customer for a specified rent and term. The bank bears all risks associated with the ownership. The *ijara* contract can be structured in a lease-purchase contract whereby each lease payment includes a portion of the asset price.

Sukuk

14. Literally, the term *sukuk* means certificates. They represent a proportionate ownership in an undivided part of an (underlying) asset. *Sukuk* may be compared to conventional bonds with the difference that *sukuk* are asset-backed. *Sukuk* may take different forms, depending on the way the contract on the underlying asset is structured. Specifically, the following forms can be mentioned:

- *Salam sukuk*. They represent fractional ownership of the capital of a *salam* transaction, the capital being constituted by the advance payment made to the supplier of the commodity (to be delivered at a future date). The gross return to the *sukuk* holders consists of the margin between the purchase price of the commodity and its selling price following delivery.
- *Istisna'a sukuk*. They represent a fractional share in an *istisna'a* project financing. The project consists in manufacturing or constructing an asset for a customer at a price to be paid in future instalments. The total amount of these instalments equals the total face value of the *sukuk*, in addition to a profit margin.
- *Ijara sukuk*. They represent a fractional ownership of a leased asset where the *sukuk* holders will collectively assume the rights and obligations of the lessor. The *sukuk* holder will enjoy a share of the lease rental proportionate to the ownership share in the leased asset. Similarly, the *sukuk* holder assumes a proportionate share of any loss if the leased asset is destroyed.
- *Musharaka sukuk*. They represent a fractional ownership of the capital of a private commercial enterprise or project. *Sukuk* holders are entitled to a proportionate share of the profits and assume a proportionate share of the losses.
- *Mudaraba sukuk*. *Sukuk* holders subscribe to the certificates issued by a *mudarib* (entrepreneur) and share the profit and bear any losses arising from the *mudaraba* operations. The returns to the holders are dependent on the revenue generated by the underlying investment. *Sukuk* holders are not registered owners and cannot attend or vote at the general assembly.

III. Application of the United Nations Model Double Taxation Convention between Developed and Developing Countries

15. The purpose of the present section is to determine which provisions of the United Nations Model should normally apply to the transactions and instruments described above. In the remaining, we will assume a treaty situation where the beneficiary of the income is a non-resident of the State where the income is derived.

16. As far as equity instruments are concerned, viz. *musharaka* and *mudaraba*, the first issue we should address is whether or not these contracts qualify for the residence status under the treaty, i.e. can a *musharaka* or a *mudaraba* venture be considered as a resident of a contracting State and qualify, therefore, for the treaty benefits.

17. The answer to this question is not obvious as both types of contracts need to be carefully studied in the light of the provisions of the treaty and the domestic laws of both contracting States (a similar issue was addressed by the Organization for Economic Cooperation and Development regarding partnerships). Nevertheless, we believe that a *musharaka* or a *mudaraba* venture would not be considered as a resident under a treaty because (most likely) it would not have a legal personality. It would have one, however, in the case where it took the form of one of the (legal) entities provided for in the company law of its State of residence. In that case, whether or not it qualified for the residence test would depend on its tax treatment under the tax law of that State.

18. Prima facie, it is clear that income derived from a *musharaka* venture is business income and should be taxed as such (if the activity amounts to a permanent establishment). The same applies to a *mudaraba* venture, with the difference that the type of investment carried on by the *mudarib* (entrepreneur) should be taken into consideration, i.e. if the *mudarib* chooses to trade in shares on the stock market, for example, the income derived by the investor (the non-resident beneficiary) will be treated as dividends or capital gains on shares, as the case may be.

19. The situation where the (non-resident) beneficiary is the *mudarib* is less obvious. The income derived in this particular case remunerates an experience or expertise in dealing in shares. It would be regarded as business income for companies, banks, etc. For individuals, it would be regarded either as income from independent personal services or as other income.

20. As regards debt and quasi-debt instruments, the situation is as follows:

(a) The profit of the *murabaha, bai salam* and *istisna'a* contracts consists in a mark-up over a cost price of an asset, commodity or product. Therefore, it is business income by nature. It will be taxable only when the activity qualifies for the permanent establishment test. This seems to be obvious in the case of *istisna'a*, as the beneficiary of income needs to manufacture or build the subject matter of the contract in the source State to sell it to the client. In the case of *murabaha* contracts, the beneficiary of income buys the commodity (subject matter of the contract) and resells it to the client in the source State. Under the United Nations Model, activities under this type of contract constitute a permanent establishment only if they are carried out through (or related to) a fixed place of business or through a dependent agent (article 5.5 of the Model). Note, however, that in the case of *murabaha* contracts, the income would be taxable under articles 6 and 13 of the United Nations Model (immovable property) if the subject matter of the contract was an immovable property and the activity of the beneficiary was not to trade in such property. As for *bai salam* contracts, the tax treatment depends on the place where the (non-resident) beneficiary sells the commodity she or he bought from the client in the source State. If the sale is made outside the source State, it will be extremely difficult to conclude that the beneficiary has a permanent establishment therein and to tax it accordingly. If, however, the sale is made in the source State, the beneficiary will be taxable (under the United Nations Model) only if she or he maintains a fixed place of business therein or the sale is made through a dependent agent;

(b) Regarding *ijara* contracts, the income is derived from the lease of the asset subject matter of the contract. Therefore, it will be taxable under articles 6 and 13 of the United Nations Model if the asset is an immovable property. If the asset is an aircraft or ship used in international traffic, then article 8 will apply. Otherwise, the income will be taxed as business income.

21. The analysis made above would remain valid, in principle, in the case where the income from the different transactions described in the previous paragraphs was made through *sukuk*.

22. However, where a *musharaka* venture qualifies for the residence test, income from *musharaka sukuk* would be regarded as dividends and taxed accordingly. The same would apply to *mudaraba sukuk*, although the holders of such *sukuk* have no voting rights and do not attend the general assembly.

IV. Conclusion

23. **Income from most Islamic financial instruments would, in principle, be regarded as business income, dividends or income from immovable property, depending on the type of contract and the underlying asset (immovable property or not). None of these instruments should normally generate income that would be regarded as interest because they were designed in the first place to avoid any (interest-bearing) debt relations.**

24. **Note, however, that some countries (e.g. Malaysia and the United Kingdom) look at some of the Islamic financial transactions as debt-financing transactions and deem (for tax purposes) payments made under such transactions as interest. The reason here is to put Islamic financial alternatives on an equal footing (from a tax perspective) with conventional financial schemes (particularly with respect to deductibility of interest versus non-deductibility of dividends, stamp duties on sale repurchase transactions, etc.).**

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